BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 89R-1332-MC
RUSSELL B., JR., AND MARGARET A. PACE	)	

Appearances:

For Appellants:	Jonathan R. Hodes Attorney at Law
For Respondent:	A. Kent Summers Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Russell B., Jr., and Margaret A. Pace for refund of personal income tax in the amount of $208,568 for the year 1986.

[1/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The question presented in this appeal is the proper construction of the term "dividend" appearing in the small business stock provisions of section 18162.5.

Appellants were shareholders of The Holden Group, Inc. ("Group"). Group was engaged in the insurance business. Prior to 1985, its business was conducted through several subsidiaries. In 1985, Group undertook a corporate restructuring. As part of the restructuring, a substantial part, but not all, of the operating assets of Group's subsidiary, Security First Group, were distributed from the subsidiary to Group. Security First Group distributed furniture, fixtures and equipment, leasehold improvements, stock of lower tier operating subsidiaries, marketing contracts, leases, and other agreements, and also distributed associated liabilities to Group. Group thereafter operated the business underlying the distributed assets. Security First Group retained some operating assets similar to those transferred to Group because consents to transfer could not be secured from the other contracting parties. Security First Group continued to operate, although at much lower levels of activity. This distribution (if considered a dividend for income tax purposes), when added to other dividends received by Group, exceeded 25 percent of Group's gross receipts for the year.

In 1986, appellants sold 100 percent of their Group shares for a gain. Appellants reported the gain as an item of tax preference on their income tax return. Subsequently, they filed a refund claim asserting that the stock qualified as "small business stock" as defined in section 18162.5 and, therefore, the gain was not an item of tax preference pursuant to section 17063.11. Respondent requested information related to Group's qualification as a small business. After audit, respondent disallowed the claim, stating that the Group stock which appellants sold did not qualify as small business stock because, in the year prior to the year of sale, Group received dividends which exceeded 25 percent of its gross receipts for the year.

Former section 17063.11 provided that the "portion of capital gains attributable to the sale of small business stock, as defined in Section 18162.5, is not an item of tax preference." Former section 18162.5, subdivision (e), enumerated several requirements an equity security must satisfy at the time it is acquired by the taxpayer in order to qualify as small business stock. In relevant part, subdivision (f) of section 18162.5 provided that small business stock does not include an equity security issued by a corporation which, in the income year immediately prior to the taxpayer's sale or exchange of the equity security, obtained more than 25 percent of its gross receipts from "rents, interest, dividends, or sales of assets." (Rev. & Tax. Code, § 18162.5, subd. (f)(1).)

Resolution of this appeal turns on the proper construction of the term "dividends." Nowhere in section 18162.5 was that term defined for purposes of that section. However, section 17321 incorporates the provisions of the Internal Revenue Code (I.R.C.) which govern taxation of corporate distributions and adjustments, including I.R.C. section 316, which defines "dividend" as a distribution out of earnings and profits. (I.R.C. § 316(a).) The parties do not dispute that, at a minimum, a dividend within the meaning of section 18162.5, subdivision (f)(1), must be a distribution out of earnings and profits. Rather, the parties' dispute is focused on whether section 18162.5, subdivision (f)(1), applies to all dividends, or only to "passive" dividends, for purposes of applying the gross receipts test of that subdivision. In this appeal, we assume, without deciding, that Security First

Group had sufficient earnings and profits to characterize the distribution as a dividend for tax purposes.[2/]

Appellants argue that section 18162.5, subdivision (f)(1), should be construed consistent with the intent of the Legislature, which they say was to deny the benefits of the small business stock provisions only for investments in corporations which engage in passive investment activity or invest in nonproductive activities producing income from rents and interest. Appellants argue that receipts from the liquidation of an active subsidiary whose business is continued by the parent are not the result of passive investment activity. Thus, appellants conclude that the distribution from Security First Group to Group did not constitute a dividend for purposes of the small business stock provisions.

Appellants draw support for their position from Franchise Tax Board Legal Ruling 428, issued on August 19, 1987 (LR 428), which addresses several questions arising under section 18162.5. In LR 428, questions 12 and 14, respondent construes the term "assets" for purposes of the phrase "sales of assets," which also appears in subdivision (f)(1). In question 12, respondent concludes that the term "sales of assets" should exclude the sale of assets used in the normal course of a trade or business. In question 14, respondent concludes that the sale of assets in accordance with a plan of liquidation adopted pursuant to section 24512 (I.R.C. § 337) would not be included for purposes of the gross receipts test if the assets sold had been used in the ordinary course of business. Appellants argue that the term "dividends" likewise should be interpreted as not applying to amounts earned "in the normal course of a trade or business," but only to those arising from passive investments. Appellants also argue that a transfer of operating assets from subsidiary to parent should not be treated any differently than a sale of the same assets. Thus, appellants conclude that the dividend was not passive and should not be considered a dividend for purposes of determining the percentage of gross receipts derived from rents, interest, dividends, or sales of assets pursuant to section 18162.5, subdivision (f)(1).

Respondent argues that the statute is clear on its face. Nowhere in section 18162.5, subdivision (f)(1), it says, does the word "passive" appear. It further argues that when a statute is clear on its face, no interpretation is necessary, and the statute must be followed as written. It concludes by arguing that "dividend" is a technical tax term defined as a distribution out of a corporation's earnings and profits and, since Group had sufficient earnings and profits, the distribution of Security First Group's assets was a dividend. Since dividends therefore exceeded 25 percent of Group's gross receipts in the year prior to the year appellants sold their Group stock, the Group stock was not small business stock.

Statutes are to be "construed in accordance with the ordinary meaning of the language used, if the words are not ambiguous and do not lead to absurdity." (Valley Circle Estates v. VTN Consolidated, Inc., 33 Cal.3d 604, 609 [189 Cal.Rptr. 871] (1983).) The interpretation accorded a statute by the agency charged with administering the statute is to be given great weight (Mel v. Franchise Tax Board, 119 Cal.App.3d 898, 911, fn. 15 [174 Cal.Rptr. 269] (1981); Coca-Cola Co. v. State

[2/] The parties briefed a variety of issues related to whether in fact this distribution would be a dividend under the consolidated return and combined report rules. Since we have assumed the distribution is a dividend, we need not resolve these issues.

Board of Equalization, 25 Cal.2d 918, 921 [156 P.2d 1] (1945)), and this board has been reluctant to substitute its own judgement unless it is persuaded that respondent's construction is clearly erroneous (see, e.g., Appeal of Estate of Philip Rosenberg, et al., Cal. St. Bd. of Equal., Aug. 19, 1975, modified Feb. 2, 1976). We have previously had occasion to consider respondent's construction of various aspects of the small business stock provisions, and there concluded that LR 428 appears to be a reasonable interpretation of the statute, within the scope of respondent's authority as the administering agency. (Appeals of Diane L. Morris Trust, et al., 89-SBE-019, Aug. 2, 1989, fn. 5.)

The very fact that respondent promulgated LR 428 interpreting the term "sales of assets" refutes its argument in this appeal that section 18162.5, subdivision (f)(1), is clear on its face. If read literally, the language of subdivision (f)(1) creates an absurd result. For example, if the term "asset" were construed in its ordinary balance sheet sense, then no business which sells products could ever qualify as a small business; only service businesses could qualify. (See FTB LR 428, supra, Question 13.) This is a result which respondent has acknowledged, in LR 428, as being inconsistent with the Legislature's apparent purpose in enacting the small business stock provisions, which was to prevent those provisions from applying to businesses which engage in substantial passive investment activity. (FTB LR 428, supra, Question 12.)

We agree with respondent's published position in LR 428, question 12, that "sales of assets" should be interpreted in a manner which is consistent with the Legislature's apparent purpose. But we also agree with appellants that there is no logical reason why the analysis and conclusion of LR 428, question 12, should not also apply to all of the other income items specified in subdivision (f)(1). Except for reciting various canons of statutory construction, respondent has offered absolutely no justification for treating these other items differently. We hold, therefore, that all the income items listed in section 18162.5, subdivision (f)(1), should be construed to include only items that are "passive" as that term is used in LR 428.

Now that we have reached this conclusion, we must next consider whether the dividend resulting from the distribution in this case was a "passive" dividend. While this dividend certainly did not arise from the operation of Group's trade or business, we believe that it was not a passive dividend, since the operating assets of the subsidiary were transferred to the parent and the parent continued operation of the business underlying the assets. Group and Security First Group reorganized themselves in a way which did not change their fundamental business operations; only the entity conducting the operations changed. We agree with appellants that the circumstances surrounding the dividend involved herein are analogous to the circumstances in LR 428, question 14, where the respondent concluded that gross receipts from the sale of operating assets in the course of a corporate liquidation are not includable in the gross receipts test of subdivision (f)(1). Consistent with respondent's rationale, the distribution of the operating assets of Security First Group to Group should not be treated as a dividend for purposes of section 18162.5, subdivision (f)(1), because it was not the result of passive investment activity. Consequently, Group did not obtain more than 25 percent of its gross receipts in 1985 from "dividends" as that term is used in section 18162.5, subdivision (f)(1), and, thus, appellants did sell small business stock. Accordingly, respondent's action in this matter will be reversed.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Russell B., Jr., and Margaret A. Pace for refund of personal income tax in the amount of $208,568 for the year 1986, be and the same is hereby reversed.

Done at Sacramento, California, this 7th day of May, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, and Ms. Scott present.

Brad Sherman, Chairman

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

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